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EXPERIENCES OF COUNTRY FUNDS AND VENTURE CAPITAL FUNDS IN DEVELOPING COUNTRIES

Report prepared by the UNCTAD secretariat

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Foreword

This report has been prepared for discussion at the UNCTAD/UNIDO "Pilot seminar on the mobilization of the private sector in order to encourage foreign investment flows towards the least developed countries (LDCs)".

It is extensively based on contributions by Mr. Terry Chuppe, Emerging Markets Institute (U.S.A.) and Mr. Michael Jordan, DFC Limited (London).

I. INTRODUCTION

1. In recent years, interest has focused on the role of non-FDI foreign investment in emerging markets in the financing of the enterprise sector of the countries concerned. Non-FDI flows are mainly equity investments in the capital of local companies in emerging markets. These investments are made by financial institutions, institutional investors (such as pension funds, insurance companies or investment trusts), or individuals interested in the financial returns of these investments.

2. The trend in foreign equity investment flows to developing countries in recent years suggests that these flows are becoming a significant source of external finance for investment. For the three years 1993-1995, total equity investment flows, including quasi-equities like convertible bonds and bonds with equity warrants, were equivalent to nearly half the FDI flows to developing countries and countries in transition[1]. The surge in equity investment in emerging markets took place against a background of structural changes in international capital markets and in the economies of recipient countries.

3. The recent period has been characterized by a seemingly irreversible process of globalization of financial markets. Financial market liberalization, as well as advances in information and communication technology, have allowed cross-border flows of capital to move swiftly between different parts of the world. The volume of these capital investments has also increased rapidly with the participation of institutional investors in the markets. The increasing importance of institutional investors, reinforced by demographic and institutional factors in OECD countries, has tended to alter the nature of financial markets. It has been estimated that insurance companies, pension funds and mutual funds in the six largest industrial countries were holding a pool of savings of nearly US$ 20 trillion in 1993[2]. In comparison, global equity market capitalization in the same year was US$ 14.1 trillion. However, it is estimated that the average share of emerging market securities in institutional investors' portfolios is only 1 per cent[3]. There is thus room for further increases in foreign equity investment in emerging markets.

4. Between 1985 and 1995, emerging stock market capitalization grew more than tenfold from US$ 171 billion to US$ 1.9 trillion, and the pace of development was much faster than that of developed markets. As a result, emerging markets' share of world stock market capitalization increased from 3.6 per cent to 12.6 per cent. At the end of 1995, emerging markets listed and traded over 17,000 companies, equivalent to about 90 per cent of the number of companies listed in developed markets.

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[1] See analysis of equity investment trends in UNCTAD: World Investment Report 1997, forthcoming. Part I. Chapter 3. "Foreign portfolio equity investment".

[2] Baring Securities: Cross Border Equity Flows, Volume II, A report by Michael Howell, Angela Cozzini, Mark Clayton (London, July 1995), p.58.

[3] IMF: International Capital Markets, 1995, p.172.

5. Foreign equity investment is made through direct purchases by individual investors of shares of companies listed in the stock markets of emerging markets, purchases of international equity offerings (including American deposit receipts (ADRs) or global deposit receipts (GDRs)) issued by companies from emerging markets on international capital markets, or investments through country funds and venture capital funds. The first two forms of investments are less frequent in low-income countries. Stock markets in these countries, if they exist, are in a nascent stage, and hence often illiquid and volatile; individual investors would therefore not take the risk of investing directly, as they are not as well informed as professional institutional investors. ADRs and GDRs are in general accessible only to large well known companies from fairly developed emerging markets which can meet the strict disclosure and reporting requirements applied to such international equity issues. Country funds and venture capital funds are thus the most common forms of equity investment in developing countries and those which can benefit the LDCs.

II. EQUITY INVESTMENT FUNDS

6. Driven by the ageing of the population in OECD countries, the growth of investable assets in the largest fifteen pension markets has been substantial during the last decade, and is projected to continue increasing in the medium term. However, less than one percent of pension fund holdings are invested in emerging markets, despite the fact that these markets account for six percent of world stock market capitalization, and that developing countries are expected to account for over one-third of the growth in world trade and output in the next ten years.

7. International investment funds (both open and closed-end funds) have become a significant form of portfolio investment in emerging equity markets. In general, closed-end funds have become a dominant form of investment in specific developing countries, but are also used to invest on a regional basis. In 1981, the first closed-end country fund was launched on the New York Stock Exchange, and the funds were invested in Mexican equities. However, the timing of the Mexico fund was unfortunate for international investors. In 1982, Mexico defaulted on its foreign debt, and the country's stock capitalization plunged from US$ 10.1 billion to US$ 1.8 billion between 1981 and 1982. As a result, the price of the Mexico fund fell 75 percent from its original offering price.

8. In 1984, the first Korea Fund was launched for public investors with a listing on the New York Stock Exchange. It was organized by the International Finance Corporation and several major investment banks. As opposed to the Mexico fund, the Korea Fund proved to be highly successful. As a result, over the next two years, 17 closed-end funds were listed on major stock exchanges for the purpose of investing in emerging securities markets. In the next ten years, the explosive growth in the number of international investment funds targeting emerging markets grew to 1283. Of these, 467 were country specific funds, and 816 (both open and closed-end funds) were organized for the purpose of investing in emerging markets on either a regional or on a global basis.

9. There are two types of managed investment companies: Open-end (often referred to as mutual funds, or unit investment trusts) and closed-end funds. Managed investment companies offer investors both professional management and diversification risk. They also provide economies of scale that can result in lower transaction costs for funds under management. Mutual funds are called "open-end" funds because they continually offer new shares to investors. After the shares are issued to the investing public they normally list and trade on an organized stock exchange. Many closed-end funds investing in new and emerging securities markets are listed on the New York, London, Hong Kong or Irish stock exchanges. Some closed-end funds list their shares on more than one stock exchange. One of the advantages of listing closed-end country funds is that some institutional investors are limited by home country prudential regulations to investing only in listed companies.

10. The number of shares offered by a closed-end fund is determined at the time of the initial public offering. Closed-end funds shares are not redeemable at the option of the investor, but rather they can be sold in the secondary market. In essence, closed-end funds trade like a typical listed stock with the market price being determined on the basis of the supply and demand for the shares. Closed-end country funds are the dominant form of investment fund for investing in

countries with new and emerging securities markets, whereas global and regional funds investing in emerging securities markets are often open-end funds.

Table 1: Stock Markets Capitalization and Trading Volume: 1986-1995
(US dollars billions)

	Market Capitalization			Trading Volume		
Year	**World**	**Developed**	**Emerging**	**World**	**Developed**	**Emerging**
1986	6,513	6,276	238	3,574	3,491	83
1987	7,830	7,511	319	5,847	5,682	165
1988	9,728	9,245	483	5,997	5,689	409
1989	11,714	10,976	738	7,468	6,303	1,166
1990	9,394	8,782	611	5,512	4,618	894
1991	11,290	10,436	855	5,016	4,411	606
1992	10,833	9,950	883	4,778	4,166	613
1993	13,964	12,377	1,587	7,703	6,634	1,069
1994	15,154	13,242	1,912	10,066	8,446	1,620
1995	17,788	15,892	1,896	11,662	10,633	1,029

Source: IFC's Emerging Stock Market Factbooks.

11. Closed-end funds may be diversified or non-diversified with respect to their investment portfolio. If a fund is classified as a "non-diversified" investment company under the U.S. Investment Company act of 1940, it is not limited in the proportion of its assets that may be invested in a single issuer. However, by investing a greater portion of its assets in a relatively small number of issuers, a non-diversified closed-end fund would be subject to greater volatility than a diversified fund.

12. Closed-end funds offer special advantages for investing in emerging securities markets which in many instances are not very liquid. For this reason, closed-end funds were also quite prominent in the early economic development of the United States capital market. Because closed-end funds are not required to meet redemption requests, or to invest new funds to meet investor's demand for further subscriptions for shares, the pool of money managed by closed-end funds is more stable than the pool of money managed by open-end funds. Consequently, closed-end country funds could be expected to take a longer-term investment horizon, which may be essential for investing in a relatively under-developed emerging securities market.

13. Closed-end country and regional funds investing in emerging securities markets offer host countries a number of significant benefits. Closed-end equity funds augment domestic savings and provide a more stable source of long-term funding than open-end funds, or bank credits. Due to their structure, it is likely that closed-end funds will have less effect on price volatility than open-end funds. This is due to the fact that if an investor in an open-end fund sell shares without an off-setting inflow of demand for shares, it may be necessary for the fund manager to sell underlying assets to repay the investor. In contrast, the sale of closed-end fund shares by an investor does not require the sale of underlying assets. Because closed-end funds are fixed in size at the time of the offering, the price is determined by supply and demand. If demand for the funds' shares are weak, the price of the fund will fall -- perhaps below net asset value -- but it is not necessary to liquidate the underlying investments held in the form of emerging market securities.

14. Managers of closed-end funds bring professional management and skills of investment analysis to markets that may not have adequate experience and training in company valuation and techniques of financial analysis. It is not unusual to find situations where local investors are unwilling to commit capital in the absence of foreign investors. Furthermore, international fund managers are likely to place greater demands on the host market for improved disclosure, more professional accounting and auditing standards, and improved market transparency. Also, it can be expected that technical enhancements in other areas such as clearance, settlement, and depository systems will be demanded by international investors. Also, foreign institutional investors are often willing to participate in training programs sponsored by international donor agencies, or local Governments, or stock exchanges. Clearly, in countries at the early stage of development, professional training in securities market operation is in short-supply. Foreign securities market professionals have helped bridge this gap in many pre-emerging securities markets.[4]

15. Closed-end funds and other institutional investors can spur the development of the local fund industry. Some countries (i.e, Pakistan) have put in place regulations that require local private investment funds to have an established foreign partner. Also, international institutional investors often are only able to invest in high-quality debt instruments. The demands of both domestic and international institutional credit ratings have helped stimulate the growth in credit rating agencies in emerging markets in the 1990s. Foreign investors' increased interest in emerging securities markets over the past decade has made it easier for companies from emerging markets to gain access to international equity and bond markets. In part, this reflects a maturation process in emerging markets. Moreover, international investors are now more familiar with companies from emerging markets than was the case at the start of the decade. Also, the presence of foreign investors may have aided the process of international capital raising in an indirect fashion -- by demanding better accounting and disclosure of corporate information -- companies from emerging securities market are better equipped to meet the accounting and disclosure requirements associated with international offerings.

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[4] See: Hans Horch. "Country Funds: An Overview." Capital Markets Board of Turkey and OECD Conference Proceedings. Current Issues in Turkish Capital Markets. Antalya, Turkey. September 3-8. 1989; and International Finance Corporation. Investment Funds in Emerging Securities Markets. World Bank/IFC. Washington. D.C., 1996.

16. The main challenge posed by foreign portfolio investment -- even in the form of closed-end funds is that new and pre-emerging securities markets are often shallow with little depth and liquidity. This poses problems for both the closed-end funds and policy makers in emerging securities markets. As discussed below, there are safeguards that may be employed by host countries to minimize the risk associated with volatile capital-flows -- including the encouragement of closed-end funds -- both domestic and international.

A. Structure and organization of closed-end funds

17. Securities regulations have a strong influence on the organization and operation of closed-end funds and other forms of investment funds. In the United States, investment companies are regulated by the SEC under the Investment Company Act of 1940. Investment companies based in the United States may be organized as corporations or they may take the form of a business trust while in most of Europe and Japan the trust arrangement is the norm. In the United States, each investment company is a separate legal entity organized under state law. The corporate form of organization is most prominent in the United States because in the early years of the establishment of the United States investment industry the vast majority of investment companies were closed-end funds. When the United States Investment Company Act was enacted in 1940, about 95 percent of investment companies were closed-end funds. As mutual funds have become the dominant form of United States investment company, the business trust form of organization has become more common. As a practical matter, however, it should be noted that the regulatory frameworks applied to investments companies in the developed markets are quite similar in basic approach regardless of the type of formal ownership structure.

18. Under the corporate form of ownership, the board of directors of the closed-end fund is not only responsible to the shareholders for the operation of the business but also have important regulatory responsibilities.[5] The board of directors (or trustees) must act on behalf of the funds' shareholders. For an investment company organized as a corporation, the Board of Directors is responsible for managing the company.[6] Typically, investment companies have contracts with others for the provision of services related to the funds operation including its management and shareholder servicing functions. In establishing the fund, the Board of Directors, will enter into a contractual arrangement with an investment advisor, underwriter, custodian, transfer agent and the external auditor. In this regard, the selection of an investment advisor is very important since

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[5] Under the business trust arrangement, the fund is established pursuant to a trust agreement whereby the trust is authorized by the Board of Trustees to issue an unlimited number (i.e., open-end fund) of shares of beneficial interest in the trust. The shareholders in the trust are entitled to vote on matters such as the approval of the investment advisory agreement and on other important matters related to the operation of the trust. As is the case with respect to corporate shareholders, each share issued by the trust has an equal right with respect to earning, dividends, redemption and the net asset value of the mutual fund. In managing the affairs of the mutual fund, the role of the Board of Directors, or the Board of Trustees, is to overseas the operation of the fund in the interest of its shareholders.

[6] For an investment company organized as a business trust, the trustees are consider to be directors for the purpose of administering regulations issued under the Investment Company Act of 1940.

it is responsible for the day-to-day operation of the fund itself and often has authority for the execution of portfolio transactions in accordance with the funds' overall performance objectives.[7]

19. There are legal constraints that can inhibit the ability of global institutional investors to buy emerging market securities. United States institutional investors, for example are subject to federal and state regulations that can have an impact on their ability to do so. In almost every state, bank trust departments are subject to the prudent mans rule that requires bank trust departments "to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." This rule has been interpreted by the courts to preclude investments in speculative securities. Furthermore, pension fund fiduciaries are subjects to a "prudent expert" rule under a United States federal law that requires that the person making judgements with respect to investments act with professional investments qualifications which is generally believed to allow a broader range of investments than the prudent man rule. In the United States, insurance companies which are regulated by the individual states rather than the Federal government, are normally required to invest in high quality securities (i.e., bonds with a high credit rating by a nationally recognized credit rating agency). One regulatory provision that would affect their ability to invest in emerging securities markets is a general requirement that no more then 15 per cent of a mutual funds assets be held in illiquid securities. Also, there is a requirement that foreign securities be held by a qualified custodian.

20. Regulatory policymakers in emerging securities markets often view closed-end funds as a means of avoiding possible harmful effects of foreign portfolio investment. Often, their policy has been to encourage foreign portfolio investment to take the form of closed-end funds rather than open-end funds or direct portfolio investment. It should be noted, however, that this has not been a very wide spread policy but it has been used in several well developed emerging markets until fairly recently (i.e., Brazil, India, Republic of Korea, and Taiwan Province of China, Turkey). In 1988, Republic of Korea was one of only five emerging market countries that limited foreign portfolio investment to special funds only.[8] By early 1991, there were only two emerging markets restricting access to special funds only -- Republic of Korea and India. Nevertheless, the number of closed-end funds investing in emerging stock markets has grown rapidly in recent years in part because such funds offer important advantages to both the international investor and the

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[7] Functional Regulation: An Analysis of Two Types of Pooled Investment Funds, United States General Accounting office Report to Members of Congress, Washington, D.C., May 1986; and The Regulation of Investment Companies in the United States, Paper prepared by the Division of Investment Management, U.S. Securities and Exchange Commission, Sixth Annual International Institute for Securities Market Development Training Conference, Sponsored by U.S., Securities and Exchange Commission, Washington, D.C., April 29 - May 10, 1996.

[8] Terry M. Chuppe and Michael Atkin, "Regulation of Securities Markets," World Bank PRE Working Paper WPS-829, Washington, D.C., January 1992, at page 23. Also, see: International Finance Corporation, Emerging Stock Markets Fact book, Washington, D.C., 1990. In 1989, only four emerging market countries were completely closed to foreign portfolio investment. Also, 17 emerging markets had a more liberal policy regime than Republic of Korea in that they were classified by IFC as free, or relatively free with respect to "openness" to foreign portfolio investment.

host countries for such investments. At year-end 1995, the IFC classified 37 emerging stock markets as free or relatively free with respect to entry and exit for foreign portfolio investment. China and the Philippines limit foreign portfolio investment to special classes of shares. Nigeria was the only country with sufficient restrictions to be classified as closed to foreign portfolio investment.[9]

21. In emerging markets, regulations may require that closed-end funds limit their investment to certain industries or the amount they invest in individual companies. Prior to granting approval, or exemptions from foreign exchange control regulations, it may be necessary for the closed-end fund to demonstrate its qualifications to conduct such a business or agree to contribute to the development of the local capital market by supporting the development of the local investment management business or by other means. Also, it may be necessary to demonstrate that the investment policy of the fund will contribute to domestic capital mobilization through participation in the new issues market rather than limiting transactions to the secondary market.

22. From an investor protection standpoint, the main objective of investment company regulation is to ensure the disclosure of full and accurate information to investors about investment companies and their sponsors. Regulation is intended to prevent: (i) irresponsible persons from managing the investment company; (ii) insiders from managing the companies to the detriment of public investors; (iii) the issuance of securities having inequitable or discriminatory provisions; (iv) unsound methods of computing earnings and asset values; (v) changing the character of the company without the permission of shareholders; and (vi) engaging in excessive leverage. In order to accomplish these objectives, investment funds requires the safekeeping and proper valuation of fund assets, restricts transactions with affiliates, limits leverage, and perhaps most importantly, imposes governance requirements as a check on fund management.

B. Country experiences

23. This section illustrates four distinct approaches to the treatment of international portfolio investment funds in emerging securities markets: (1) Republic of Korea, (2) Sri Lanka, (3) China, and (4) Viet Nam. In the case of Republic of Korea, Government policy actions were intended to restrict foreign portfolio investors access to the Korean securities markets and to protect the Korean securities industry from external competition. Although several steps toward liberalization were taken along the way, this policy was consistently followed for nearly 30 years. With the internationalization of the world's securities markets in the 1980s, however, a policy shift led to the gradual opening up of the Korean securities markets to closed-end funds and other forms of cross-border portfolio investment. In 1989, the Sri Lankan Government initiated a program to facilitate the development of the local equity market that took into account the need to attract foreign portfolio investment. The policy framework adopted by Sri Lanka encouraged the participation of foreign portfolio investors, including closed end-country funds set up for the purpose of investing in Sri Lanka. In granting access to foreign closed-end funds, such funds were required to demonstrate a willingness to participate in the primary market and assist in the

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[9] At year-end 1995, five emerging markets limited foreign portfolio investment to authorized investors only: Colombia, Jordan, India, Mauritius, and Taiwan Province of China. See: International Finance Corporation, Emerging Stock Market Fact book (1996), World Bank/IFC, Washington, D.C., May 1996, at page 276.

development of the local fund management industry. With exchange control considerations in mind, China adopted a policy which requires foreign portfolio investors to limit their participation in China's domestic stock market to the purchase of a specific class of shares reserved for foreign investors. While the creation of separate classes of shares for domestic and foreign investors has resulted in price distortions in the stock market, this policy is likely to continue until such time as the local currency becomes fully convertible. Finally, Viet Nam represents a case where closed-end funds have been established with the expectation that a stock market would be established in the future. The Viet Nam experience suggests that it may be best to establish the local infrastructure for a stock market, including an appropriate regulatory framework, prior to granting access to investment funds that are publicly traded on international stock exchanges. For a pre-emerging market such as Viet Nam, private venture capital funds with a long-term investment horizon (i.e., three to five years) would appear to be a more suitable investment vehicle.

1. Republic of Korea: liberalization experience

24. From 1985 to 1989, Korean stock market capitalization increased from US$13.9 billion to US$140.9 billion while the number of listed companies expanded from 355 to 626. There was also a substantial run-up in stock prices. From 1989 to 1991, however, stock market capitalization fell by more than 40 percent (from US$140.9 billion to US$96.4 billion). Trading volume on the Korean Stock Exchange (KSE) also dropped about 40 percent over this period. The KSE was largely closed to foreign portfolio investment at the time of the downward price spiral. Thus, it was attributable entirely to a loss of confidence by local investors. From 1992 to 1995, the Korean stock market resumed its growth. Stock market capitalization more than doubled over this period, totalling US$141.2 billion at year-end 1995.

25. In the 1980s, a number of steps toward liberalization were announced by Republic of Korea to open the domestic securities market to direct foreign portfolio investment and to improve access for foreign securities brokers-dealers. Nevertheless, the pace of implementing the liberalizations was quite slow. It was not until a decade later, when stock market conditions required decisive government action, that the reforms actually moved forward. In January 1981, Republic of Korea announced a policy that called for the gradual internationalization of the domestic securities market through a four step process:

- Indirect access was planned by means of international closed-end investment funds (i.e., closed-end funds) that would be permitted to invest in the Korean domestic securities market;

- Foreign securities firms were supposed to be allowed to open branch offices in Republic of Korea based on reciprocal arrangements;

- Foreign portfolio investors were to be granted limited direct access to the Korean securities market in the mid-1980s; and

- Korean investors were to be able to invest in foreign securities by the early 1990s.[10]

26. In November 1981, the first step in the liberalization of the Korean securities market to foreign investment occurred with government approval of the issuance of international investment trusts for foreigners. The initial limit was US$30.0 million. As a result, two small privately placed investment trusts were launched in the United Kingdom. The international investment trusts were intended to allow foreign investors limited access to the Korean securities market. Local investment companies were in charge of the trust which had irrevocable terms for the redemption of investment principal and proceeds. These privately placed investment trusts served as a pilot for the first public offering of the Korea Fund. In 1984, the Ministry of Finance (MoF) approved the first closed-end country fund for investment in the Korean securities market. In August 1984, the US$60 million Korea Fund was launched with a listing on the New York Stock Exchange. This followed several years of preparation by the Korean Government. A second public offering of the Korea Fund took place in 1986, followed by a third tranche in 1989 and a fourth in 1995. With the success of the Korea Fund, the government allowed a second closed-end fund to be offered in London. In March 1987, the Korea Europe Fund valued at US$30 million was brought to the market with a Korean securities firm serving for the first time as lead manager. In 1990, the government authorized a third closed-end fund investing in Korea -- the Korea Asia Fund with an initial capital of US$100 million. The Korea Europe Fund and the Korea Asia Fund are both listed on the Irish Stock Exchange. From 1984 to 1995, the three closed-end country funds were able to raise US$690 million for investment in the Korean securities market. In addition to the three Korean country specific international closed-end funds, there are about 90 global and regional international emerging market funds investing in the Korean securities markets with a net asset value of about U.S.$5.1 billion.

27. When the initial Korea Fund was offered to international investors in 1984, there were considerable restriction on foreign portfolio investment in Republic of Korea. Foreign portfolio investment was allowed only with the approval of the MoF. Under the Korean foreign exchange control laws there were substantial restrictions on foreign investment, the repatriation of capital, and the conversion of investment principal from Won to U.S. dollars. Also, the MoF had the power to revoke foreign exchange permits and to establish limits on overbought or oversold positions in foreign exchange. There were also limits on foreign portfolio investments in a particular industry and with respect to individual listed companies. Thus, a single foreign investor could not own more than five percent of a class of equity securities of a particular company while foreigners as a group were subject to a ten percent limit.[11]

28. By the end of the 1980s, a series of reforms began to be put in place. In 1989, Republic of Korea expanded access by existing international investment funds and allowed a wide range of off-shore financial transactions by Korean companies in the international capital market. In 1990, Republic of Korea established legal standards for setting up branches and joint ventures in Republic of Korea by foreign securities firms. In 1991, Republic of Korea permitted limited direct

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[10] Terry M. Chuppe and Michael Atkin. "Regulation of Securities Markets." World Bank PRE Working Paper WPS-829, Washington, D.C., January 1992, pp. 26-27.

[11] Korea Fund Inc., Prospectus, August 22, 1984, pp. 8-9.

foreign portfolio investment in the domestic securities market. Until this time, foreign investment had been restricted to participation in approved investment funds. It also allowed Korean securities broker-dealers to open branches outside the country and foreign securities firms were authorized to establish branches in Republic of Korea.[12]

29. Following a 23.5 per cent decline in the Korean stock market in 1991, additional steps were taken to encourage foreign portfolio investment.[13] In January 1992, foreign portfolio investors were permitted to invest in all stocks listed on the Korean Stock Exchange subject to certain guidelines: (1) foreign investors in the aggregate could own up to 10 percent of a Korean listed company but a single foreign investor was subject to a 3 percent limit; (2) foreign investment capital was allowed to be repatriated with only limited exceptions; and (3) the Government implemented procedures to monitor foreign securities transactions. As a result of the liberalization, net foreign portfolio equity flows increased from US$345 million in 1991 to US$6.0 billion in 1993.[14]

30. In 1995, further liberalization of foreign portfolio investment was implemented. As a result, the total foreign ownership limit on listed stocks was raised to 12 per cent and the documents necessary for foreign investment registration were reduced. Also, the period needed to review an investment registration was reduced from two-three weeks to three-five days. In order to receive an investment registration card, foreigners must register with the Korean Securities Supervisory Board (SSB). Prior to the January 1992 liberalization, there were 565 foreign investors from 19 countries registered with the Korean SSB. At year-end 1995, the number of foreign investors registered with SSB had increased to 4,286. Of the foreign registrants, 1,520 were individuals and 2,766 were institutional investors, including 1,864 investment companies, 351 pension funds, 181 banks and 85 insurance companies.[15]

31. The Republic of Korea has taken a cautious approach to foreign portfolio investment. There is no justification in the economic theory of regulation to justify such restrictions on foreign portfolio investment.[16] On the other hand, there are very good reasons to believe that foreign portfolio investors can facilitate securities market development. Moreover, they often demand that local securities regulatory bodies move forward in implementing international disclosure and

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[12] Securities Markets in Korea: 1996. Korean Securities Dealers Association. Seoul. April 1996. pp. 109 - 129 and Securities Market in Korea: 1995. Korean Securities Dealers Association. December 1994. pp. 101 - 124.

[13] In reaction to the stock market decline that began in mid-1989, the government also attempted to stabilize stock prices by establishing a stabilization fund. By the end of 1990, it was estimated that the stabilization fund held five percent of listed shares outstanding. Nevertheless, the ability of such funds to materially affect stock price are limited. See: Chuppe and Atkins, op. cit., at page 31.

[14] World Bank, World Debt Tables: External Finance for Developing Countries - 1996. Volume II. Country Tables. World Bank/IFC. Washington D.C., 1996. p.246.

[15] Korean Securities Dealers Association. Securities Markets in Korea. Seoul. Korea. April 1996. pp. 109-114.

[16] See: Chuppe and Atkin. op. cit., at p.33.

accounting standards and policies that will make the market more transparent. When the Korean stock market stabilization fund proved to be inadequate in stabilizing prices, Republic of Korea took prompt steps to liberalize its policy with respect to foreign portfolio investment. While the pace of liberalization was slow, the Korean stock market is now classified by the IFC as relatively free to foreign portfolio investment.

2. Sri Lanka: open market to foreign portfolio equity investment

32. The Sri Lankan policy throughout the 1990s encouraged the development of the local stock market coupled with a policy to encourage participation by foreign investors. Few restrictions apply to foreign portfolio investment in the equity shares of companies listed on the Colombo Stock Exchange (CSE). Moreover, foreign firms have been allowed to participate in the local fund management industry, the stock brokerage business, and the investment banking business.

33. From 1991 to 1996, the number of listed companies on the CSE increased from 178 to 235. In Sri Lanka, the stock market infrastructure (i.e., the trading system, clearance and settlement, etc.) was developed in keeping with international standards.[17] The clearance and settlement process is fully automated. All share transactions are effected via a book entry as soon as trade details are entered into the Central Depository System (CDS). A new automated trading system is in the process of being implemented by the CSE. At the present time, the CSE has three trading boards. It has a Main Board for larger companies with a more active trading market and a Second Board for smaller less active companies. In addition, a separate over-the-counter market does not exist in Sri Lanka but less active issues are traded on the CSE's Over-The-Counter Board.

34. Since 1995, macroeconomic conditions have not been conducive to capital mobilization through the securities markets. Consequently, the number of new listings through the public offering of shares declined from 15 in 1994 to 9 in 1996. While annual turnover declined from a peak of Rs 34.5 billion in 1994 to Rs7.4 billion in 1996, foreign participation in the stock market has increased sharply relative to local investors. From 1993 to 1996, the share of total turnover on the stock exchange accounted for by foreign investors increased each year -- from 35 per cent in 1993 to 55 percent in 1996. On balance, foreign investors were net buyers (i.e., purchases exceeded sales) of Sri Lankan stocks during the 1993-1996 period while local investors were net sellers. Thus, foreign portfolio investors have been a more stable source of trading volume than local Sri Lankan investors during a period of contracting stock prices and substantially reduced secondary market trading.

35. Throughout the 1990s, government policy has facilitated foreign portfolio investment in Sri Lankan listed companies. In general, foreign portfolio investment (i.e., closed-end funds or other forms of portfolio investment) in the shares of limited liability companies listed on the CSE

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[17] At the present time, an Electronic Order Matching trading system is being installed. The new automated trading system will replace the current open outcry system using trading floor boards and floor brokers. The Electronic Order Matching Screen based trading system will enable brokers to trade from their own offices. The new trading system has the facility of an electronic order book which is expected to give brokers and investors greater visibility of the market. See: Colombo Stock Exchange Fact Sheet (1996).

is not restricted. Investments made after 5 June 1990 are not subject to exchange control regulations. Foreign portfolio investment in the Sri Lankan equity market is permitted for country funds, regional funds, investment, and trust funds with prior approval from the Ministry of Finance. Companies incorporated outside Sri Lanka and individuals residing outside Sri Lanka are also permitted to invest in the local equity market.

36. Under Sri Lankan exchange control regulations, investment in Sri Lanka and the repatriation of the proceeds must take place through a Share Investment External Rupee Account (SIERA) opened with a commercial bank. Foreign investors may also make payments through their foreign broker. In this instance, there must be evidence of an inward remittance of foreign currency for the payment, and the payment must take place through the foreign brokers SIERA. With the exception of the commercial banking, the insurance industry and residential housing, foreign investment in listed companies normally is permitted up to 100 per cent of the equity in each company. In the case of banks falling within the scope of the Banking Act (No. 30) of 1988, foreign investors are permitted to own up to 49 per cent of local Sri Lankan banks. For companies involved in residential housing and mining, foreign investment is limited to 40 percent ownership in such companies.[18] Under regulations issued by the Controller of Insurance, foreign investment in Sri Lankan insurance companies is not permitted. In Sri Lanka, however, the insurance industry is relatively small with about 70 per cent of the insurance industry premiums written by the two state-owned insurance companies. Foreign investors may sometimes be granted concessions from such restrictions. The Sri Lankan Growth Fund, for example, was granted permission to acquire the shares of insurance companies.[19] In 1995, foreign investors accounted for nearly one-half of the Rs11,249 million in trading volume on the CSE compared to only 35 per cent four years ago. Without the continued support of the foreign investment community through joint venture stock brokerage and money management firms as well as continued trading support, the CSE would be a less viable institution.

37. Under the current tax scheme for Sri Lanka, capital gains derived from the sale of portfolio investments in a listed company are not subject to a capital gains tax. Capital gains on unlisted Sri Lankan securities is subject to taxation. Dividends are subject to a 15 per cent withholding tax. In Sri Lanka, double taxation treaties do not exempt withholding tax.[20] For the remittance of dividends abroad, tax clearance must be obtained, confirming that applicable withholding tax has been paid. Since Sri Lankan companies deduct the tax at the source, this is a fairly routine administrative matter. At the present time, foreign investors are not permitted to purchase corporate or government debt securities. Also, they are not permitted to purchase Sri Lankan unit investment trusts. This policy has hindered the development of the debt securities market and of the unit trust business.

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[18] Under the Articles of Association, an individual listed company may restrict foreign participation in the ownership of the company.

[19] See: Sri Lanka Growth Fund. Preliminary Placing Memorandum dated 7th February, 1994 at page 6.

[20] Securities Services: Colombo Sri Lanka. Hong Kong Bank, member HSBC Group. August, 1996 at page 7.

38. There are two closed-end country funds as well as several regional and global emerging markets investment funds investing in Sri Lanka. The two closed-country funds -- the Regent Sri Lanka Fund Limited and the Sri Lanka Growth Fund were established in 1993 and 1994, respectively. For investment in Sri Lankan, such funds must obtain approval from the Ministry of Finance as well as adhere to certain principles. In addition to meeting the home country regulatory requirements, closed-end country funds investing in Sri Lanka are expected have to the following attributes:

- maintain a developmental character (i.e., in addition to investment in the secondary market, the fund must plan to invest in initial public offerings and unlisted shares);
- arrange for the transfer of fund management technology to Sri Lanka and willingness to participate in the equity of fund management companies located in Sri Lanka;
- experience in structuring country funds, particularly in the Asian region;
- exhibit a suitable fund structure with respect to the fund itself, fund management, investment advice, custodianship, investment guidelines and arrangements for listing.
- reasonableness in fee structure; and
- an initial investment of US$25-30 million.

39. The Regent Sri Lanka Fund Limited is designed to enable non-Sri Lankan investors to invest indirectly in Sri Lanka. The investment policy objective of the fund is to achieve capital growth by investing in a diversified portfolio consisting primarily of equities listed on the CSE and equity related securities, including convertible bonds and warrants issued by Sri Lankan companies outside Sri Lanka. The Fund is a limited liability company incorporated in the Cayman Islands. It is listed on the Irish Stock Exchange. During the initial subscription period, about US$30 million in capital was raised in the form of 3 million participating shares offered at an initial subscription price of US$10.30.

40. Under the investment policy adopted by the Regent Sri Lanka Fund's directors, the following are the main criteria for investment: (i) no more that 10 per cent of the fund's net asset value may be invested in a single company; (ii) no more than 5 per cent of the fund's net asset value may be invested in unlisted securities, other than securities evidencing indebtedness issued or guaranteed by governments or banks or linked to listed securities; (iii) in the case of privatization, where the manager reasonably expects that the company will be listed within six months of the acquisition of shares, the investment maximum is 10 per cent of the fund's net asset value; (iv) the fund may only invest in equity or equity-linked securities of companies or bodies incorporated or established in Sri Lanka; (v) the fund may not acquire more than five percent of the share capital of any listed Sri Lankan company; (v) without the express consent of the directors, the fund may not invest in any other open-end mutual fund or open end collective investment scheme other than those listed on the CSE which invest primarily in equity securities

issued by CSE listed companies. Furthermore, the fund may not invest in land or commodities, commodities contracts, or commodities futures contracts.

41. The Sri Lanka Growth Fund is also listed on the Irish Stock Exchange. The primary objective of the fund is to achieve capital appreciation through investments in companies operating in Sri Lanka through investments in equity securities listed on the CSE. If available, the fund may also invest in Sri Lankan companies listed on major international stock exchanges. The fund may also invest in unlisted companies in Sri Lanka or in the listed securities of non-Sri Lankan companies which derive a significant part of their revenue or profit from Sri Lanka, or have or expect to have substantial assets in Sri Lanka. The Sri Lanka Growth Fund identified five sectors that its investment manager believed would present opportunities for investment: (i) infrastructure development projects, (ii) export processing companies, (iii) textile production, (iv), agricultural processing (i.e., plantation companies) and (v) tourism related projects. With regard to unlisted securities, the fund will not invest more than 25 per cent of its net asset value in such securities. The fund is not intended to be a provider of "venture" capital. Consequently, the fund will only invest in unlisted companies that have a reasonable expectation of obtaining a listing within a reasonable period of time.

42. Sri Lanka has also issued regulations regarding regional funds. Regional funds are defined to be funds floated abroad for the purpose of investing in the Asia region by persons or institutions who are non-residents. Regional funds investing in Sri Lanka are expected to fulfill the following criteria:

- arrangements for the transfer of fund management technology to Sri Lanka;
- experience in investment in securities markets with particular reference to Asian emerging markets;
- suitability of the funds operating structure -- the fund itself, fund management, investment advice, custodianship, and investment guidelines;
- experience in the fund management business.

43. The domestic investment company industry has also been encouraged through Government policy actions in Sri Lanka. The Government established the regulatory framework for the fund industry under the supervision of the Securities and Exchange Commission, granted a five year tax holiday to unit investment trusts, and encouraged foreign participation the ownership of the local fund management industry. At the present time, there are four local investment management companies which each sponsor a unit trust (i.e., mutual fund) investing in listed companies. In Sri Lanka, unit trusts are defined to be collective investment vehicles, where funds are pooled and invested on behalf of unit holders by a professional fund management company. Unit trusts invest in equity securities and other domestic financial instruments such as bonds and warrants. The portfolio is divided into units, and investors can buy and sell the units which are traded on the basis of the net asset value of the unit. As investors make additional

contributions to the pool, additional units are issued and fund managers invest the cash on behalf of the unit holders.[21]

44. Each of the four local Sri Lankan fund management companies has a foreign partner. The Securities and Exchange Commission recently authorized the establishment of a fifth investment management company. Also, the securities regulations have been modified to allow Sri Lankan fund managers to sponsor more than one open-end investment fund (i.e., mutual fund). Thus, it will be possible for fund managers to offer investors a wider range of investment funds such as (i) stock funds, (ii) funds investing exclusively in debt instruments or (iii) diversified funds investing in stocks, corporate bonds and Government securities. In addition to the four open-end funds currently available to Sri Lankan investors, there are also five closed-end investment companies listed on the CSE. In Sri Lanka, the foreign fund managers participating in the Sri Lankan securities market have facilitated the development of the local fund industry in keeping with Government policy to encourage the development of the local fund industry as well as encourage foreign portfolio investment.

3. China: limitations on market access - A shares and B shares

45. The development of China's equity market began informally in the 1980s. Stocks were first issued to employees of an enterprise rather than to the general public. Starting in 1984, shares began to be offered to the public. An informal share market commenced operation shortly thereafter. In China, the concept of share ownership is formally recognized in the company law. Shares are now issued in perpetuity to individual and institutional investors. Shares of Chinese companies are now listed and traded on China's domestic and international stock markets. Since the Shanghai and Shenzhen exchanges were formally recognized on December 19, 1990 and July 3, 1991, respectively, China's stock markets have experienced rapid growth. From year-end 1991 to February 1996, the number of companies listed on China's two domestic exchanges grew from 14 to 573, while the stock market capitalization increased from US$2.0 billion to US$140.6 billion.

46. In 1992, the first closed-end country fund investing exclusively in China was launched with a listing on the Hong Kong Stock Exchange. By 1993, a total of 18 China country funds were available to foreign investors, providing about US$3.0 billion in foreign investment to China. As is common with closed-end country funds, most China country-funds have traded at discounts from net asset value. While initially superior to other emerging markets due to the relative scarcity of China funds, a World Bank study of China's capital market found that the performance of China funds deteriorated relative to that of other country-specific closed funds in the third-quarter of 1994.[22]

47. Foreign portfolio investment in China is limited to a specific class of shares reserved for foreign investors only. Five classes of shares exist in China: A, B, H, N, and S shares. In China,

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[21] Securities and Exchange Commission of Sri Lanka. Administrative Report, 1995, at page 36.

[22] World Bank, China: The Emerging Capital Market, Volume II, Detailed Technical Analysis, Report prepared by the Country Operations Division, China and Mongolia Department, East Asia and Pacific Region, World Bank/IFC, Washington D.C., November 3, 1995

A shares are reserved for domestic investors, B shares are available to foreign portfolio investment in the local Chinese stock exchanges located in Shanghai and Shenzhen. Foreign portfolio investors are also able to buy and sell sale H Shares listed on the Hong Kong Stock Exchange (HKSE), shares listed on the New York Stock Exchange (NYSE), or S shares listed on the Singapore Stock Exchange (SSE). B shares, which have the same ownership and voting rights as A shares, are available only to foreign portfolio investors and residents of Hong Kong, Macau and Taiwan. Since July 1993, H shares have been listed on the HKSE. H shares are traded in Hong Kong dollars. N shares refer to Chinese companies listed on the NYSE and traded in the form of ADRs. The segmented market structure has resulted in divergent price patterns offering arbitrage opportunities that create legal and regulatory problems. While A shares and B shares have the same dividend and voting rights, their respective prices move together only weakly over time. The possibility for arbitrage can lead to illegitimate transactions (i.e., the purchase of a shares by non-residents), lower liquidity, and reduced stock market transparency. Furthermore, the incentive to engage in transactions not permitted by law can create significant problems for the securities regulators who monitor stock market transactions in order to detect insider trading, or stock market manipulation. The World Bank has recommended that the distinction between A shares and B shares should be eliminated.[23] Concerns about the limited convertibility of the RMB, or the possibility of excessive capital inflows or outflows could be dealt with by other means such as those employed by Korea and other Asian markets at an early stage of equity market development.[24]

48. With regard to investment funds in China or overseas funds investing in China the legal and regulatory framework is rudimentary. The only national legislation is one concerning foreign joint ventures enacted in 1995. In general, the People's Bank of China is responsible for the approval of all investment funds in China including those set up overseas to invest in China's securities markets

49. There is a clear need for a national law that would apply to all aspects of the fund management business.[25] Nevertheless, there are more than 100 international emerging market equity funds investing in China (including China related "concept" funds) at the present time with a net asset value of US$6.8 billion.

50. The World Bank staff report on China's capital market identified several alternative safeguards which might provide a less burdensome methods to restrict portfolio investment flows than market segmentation, including:

- A ceiling may be applied to foreign investment at the enterprise, sectorial, or individual levels;

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[23] World Bank China Study, op. cit., at page 178.

[24] With regard to currency convertibility, it is noteworthy that Korea, for example, permitted foreign portfolio investment in domestic equities before full convertibility was implemented.

[25] See: "Regulation of Securities Market Activities and Mutual Fund Management," Chapter 3, China's Non-Bank Financial Institutions: Trust and Investment Companies. World Bank Discussion Paper No. 358. World Bank, 1997.

- Participation might be limited to certain approved investors with pre-approved credentials such as trust funds or country funds;

- Secondary market transactions which might be viewed as de-stabilizing might be restricted (i.e., short-selling or buying on margin);

- Restrictions on voting rights or membership on a company's board of directors might be imposed on certain classes of shareholders in the event that local control is desired.[26]

4. Viet Nam: country funds but no stock market

51. In Viet Nam, an organized stock exchange, or over-the-counter trading market does not exists at the present time. There is, however, a primary market in Treasury bills and Government bonds. Earlier this year, the Finance Minister reportedly indicated that a stock exchange was unlikely to begin operation prior to 1999.[27] It is likely that a Vietnamese securities exchange will begin operation sometime in 1998 with trading in debt instruments followed by the introduction of stock trading somewhat later. In November 1996, a decree was enacted mandating the establishment of a State Securities Commission (SSC) in Viet Nam. A national securities law has not been enacted. However, initial draft legislation is in the process of formulation. It is possible that a securities law or perhaps administrative guidelines for the operation of a securities market could be in place by year-end 1997 or early 1998. The SSC will be responsible for preparing the legal and regulatory framework for the securities market and facilitating the development of the securities market infrastructure.

52. In Viet Nam, the companies law allows foreign investment in joint stock commercial banks, but it is apparently silent on the extent to which foreign ownership will be permitted for other types of joint stock companies. At the present time, this is decided on a case by case basis. In order to facilitate the future development of the securities market, the Companies Law must be modified. Also, laws and regulations governing the participation of bank and non-bank financial institutions in the capital market need to be formulated and implemented.

53. Although the infrastructure for a stock market and the related regulatory framework does not exist, seven closed-end country funds have been organized for the purpose of investing in Viet Nam. Of these, six are listed on international stock exchanges and one is a closely-held private venture capital fund. One closed-end fund with the investment objective of investing in Viet Nam is listed on the NYSE and five are listed on the Irish Stock Exchange. The net asset value of closed-end country funds with the investment objective of investing in Viet Nam has grown from

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[26] It is important to keep in mind that such safeguards differ from foreign exchange controls on the repatriation of capital and dividends. See: World Bank, China: The Emerging Capital Market, Volume I, Strategic Issues and Options, Detailed Technical Analysis. Staff report prepared by the Country Operations Division, China and Mongolia Department, East Asia and Pacific Region, World Bank/IFC, Washington D.C., November 3, 1995.

[27] Indochina Country Funds Review, Ing Barings, Country Funds Research, October 1996.

US$10 million in 1991 to an estimated US$400 million at year-end 1996.[28] The smallest of the six listed closed-end funds (Dragon Capital) with net assets of about US$16.6 million trades at a premium over net asset value of about 10 per cent, while the other five listed funds are trading at a discount ranging from 20 to 30 per cent.[29]

54. The number of Viet Nam country funds has grown with the expectation that they will be able to invest in companies that will list on Viet Nam's future stock market. While there has been substantial investor interest in the prospects of investing in Viet Nam, the securities market and the related infrastructure is still at the initial stage of development. Consequently, investment opportunities in companies that may potentially list on a future stock exchange, or issue debt securities are quite limited at this time. As a result of the scarcity of suitable investments in Viet Nam, most of the funds have large cash positions available for future investment. Most of these funds were organized several years ago with the expectation that a stock exchange would soon open. Most observers, however, do not expect a Vietnamese stock exchange to open until 1998 or perhaps even later. Thus, it may become necessary for several of the "Viet Nam" closed-end country funds to change their investment objective, or even liquidate the fund. One possibility would be for such funds to become regional funds pending the start-up of a stock market in Viet Nam.

55. As has been the case in most emerging markets at an early stage of development, it will be necessary for Viet Nam to implement policies to facilitate the development of the capital market. This would include clarity in the tax regulations with respect to treatment of capital gains on portfolio investment in stocks and bonds, tax incentives for closely-held business enterprise to issue shares to the public and the treatment of dividend income on the same basis as interest income received from deposit-taking institutions. One important policy issue is the pace of privatization. Thus far, Viet Nam has elected to "equitize" relatively small scale state-enterprises. Under the current policy, the government retains a 30 per cent ownership interest in equitized state enterprises with the remaining shares issued to employees and local investors. So far, however, the pace of equitization has been relatively slow. For the stock market to achieve a meaningful size, listing shares of state-enterprises through a large scale equitization program will be necessary. It will also be necessary for Viet Nam to encourage the development of a critical mass of financial instruments and the development of non-bank financial institutions including investment banks, pension and provident funds, as well as other types of institutional investors such as collective investment funds (i.e., closed-end funds), insurance companies and bank trust services.

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[28] The seven listed country funds investing in Vietnam (with net asset value in millions of US dollars) are: Beta Viet Nam Fund (US$69.3), Lazard Vietnam Fund (US$59.1), Templeton Vietnam Opportunities Fund (US$115.8), Vietnam Enterprise Investment Fund (US$16.7), Vietnam Frontier Fund (US$67.2) and the Vietnam Fund (US$58.2).

[29] See: Asian Wall Street Journal, February 27, 1997 and The Big Money, the Vietnam Business Journal, April 1997, pp. 22-24.

C. Building an effective policy and regulatory framework

56. Government policy with respect to foreign portfolio investment and access to the local capital market by international closed-end country funds should be examined in the context that the benefits of foreign participation should be achieved with minimal potential harmful effects. In large measure, this means building up the local capital markets' infrastructure and regulatory regime so that the markets can function in an operationally efficient manner. At the outset, policymakers should recognize that stock markets are volatile even in the absence of foreign investment. In fact, emerging stock markets have on occasion been opened to foreign investment in an effort to off-set the lack of sufficient local demand for investment in the stock market. In the case of closed-end funds, they are unlikely to withdraw from the market even in the absence of local investors' participation.

57. If foreign portfolio investment is restricted, the reasons for such restrictions must be carefully considered. Policies that might favour local investors or institutions at the expense of foreign participation in the local market must be carefully examined to determine if they are really necessary since such policies can retard the development of the local securities market infrastructure. In this regard, Sri Lanka offers an interesting example whereby foreign portfolio managers and securities firms were encouraged to participate in the establishment of the local fund management and securities brokerage and underwriting business. The Republic of Korea, on the other hand, was quite slow to open-up its domestic capital market and securities industry to foreign participation. Moreover, it is unlikely that the policies followed by Republic of Korea in the 1970s and 1980s could be replicated in an era of global economic and financial market integration. Since the mid-1980s, the trend has been toward an early opening-up of emerging securities markets to foreign portfolio investment. In many emerging markets, including China, Pakistan and Sri Lanka, foreign securities firms have been able to participate in the development of the local capital market infrastructure through joint venture operations with local securities firms.

58. When countries delay foreigners' access to the local market to a more advanced stage of development, this makes the transition to a more liberal regime more difficult. This takes on special significance at the more advanced stage of capital market development when local securities firms must be able to compete with foreign providers of financial services in the local and international capital markets. In general, foreign investors would like to receive the same treatment as local investors. From the foreign investors' viewpoint, a consistent policy framework with regard to the treatment of foreign portfolio investment is most important. Sudden policy changes can result in uncertainty which ultimately increases the risk of transacting in emerging securities markets for both foreign and domestic investors. Sudden policy shifts may also contribute to financial markets volatility and contribute to systemic risk.

59. Policy actions that make securities markets attractive to local investors will also create an environment that raises international investors' confidence. Even with the implementation of a sound regulatory scheme and the creation of a strong market infrastructure, it must be remembered that financial markets by their very nature are volatile. Often such volatility is associated with underlying macroeconomic conditions that in some instances may not be within the control of national policy makers. From the standpoint of the regulation of securities markets, the most important policy task for regulators is to have in place the systems and procedures

necessary to deal with unexpected events that may give rise to temporary price instability. If the systems and procedures are in place to deal with problems that may arise, both domestic and foreign investors will have confidence in the market.

60. In countries at an early stage of securities market development, a well formulated public education and awareness program should be implemented to make investors aware of both the risks and rewards of share ownership. In this regard, it may be useful to provide training seminars to the local financial press on the operation of the capital market and the role of foreign investors. This may improve the quality of information reported to investors by the financial press. Investors also should be made well aware that one of the risks of owning financial assets is price volatility. While investors need to be assured that prudential standards are adequate to protect the safety and soundness of the financial system, governments should not encourage investors to believe that they have the ability to control the level and direction of stock prices. One area that governments can be particularly effective in emerging markets is to make sure that the process of privatization through the capital markets is conducted in a fair and transparent manner. In this regard, the government needs to ensure that the mechanisms are in place so that both domestic and foreign investors have a reasonable expectation that an investment in a state-owned enterprise will be a favourable experience. Also, a well formulated policy of privatization through the local capital market over an extended period of time can contribute to gradual improvement in the depth and liquidity of the local stock market. One strategy that can be employed at the early stage of development is to privatize in a manner that includes equity participation by a strategic private investor that will improve the management of the enterprise. Also, broad public participation in the privatization will not only improve the depth and liquidity of the local capital market but also create greater public support for future privatization efforts. In the absence of a well founded strategic framework for the development of the local capital markets and the related infrastructure, it is unlikely that a pre-emerging market can reap the full benefits of foreign portfolio investment.

61. If emerging capital markets are to function efficiently, certain guiding principles need to be adhered to with respect to market development, foreign investors' participation and regulation:

- Markets should be allowed to set the prices of individual securities based upon supply and demand. Firm commitment underwriting by well capitalized securities firms or investment banks should be encouraged. If local firms are not able to perform these functions in an efficient manner, joint ventures with foreign firms should be encouraged. Governments should not be involved in the pricing and selection of issues.

- Restrictions on entry into the securities business should be concerned with maintaining high prudential standards rather than limiting competition. Foreign securities brokers-dealers and investment funds should be encouraged to participate in the domestic capital market in order to encourage the transfer of technical skills and to upgrade professional standards within the securities and fund management industry.

- Policies that encourage competition and innovation will result in an array of financial instruments that will foster the development of the demand and supply

side of the market. In order for an emerging securities market to have adequate depth and liquidity, there must be a critical mass of instruments to make the provision of financial services to the market such as brokerage, market making, fund management and research economically attractive.

- Market development can be aided by allowing foreign portfolio managers including closed-end funds to participate in the development of the local fund management business and by encouraging the development of domestic institutional investors such as mutual funds, pension funds and insurance companies. While the transactions of small individual investors can help provide market liquidity, they are more likely to suffer from informational asymmetry than the more sophisticated institutional investors.

- For small pre-emerging capital markets, consideration should be given to tying foreign closed-end country funds' or regional funds participation to their willingness to contribute to the development of the local capital market infrastructure. This might take the form of a joint venture operation with a local fund management firm, or in providing training to local market professionals or assisting local authorities in the development of a program of investor education.

- The securities regulatory body should be independent and self-funded in order to encourage the development of a regulatory framework that will instill public confidence. Adequate funding for the securities regulatory body is essential in order to encourage the development and retention of qualified personnel to supervise complex securities market transactions. This would also help insolate market regulators from policy reversals which sometimes have a political rather than an economic or investor protection rationale.

- Investor protection and market efficiency require a well informed investing public. Public awareness and education programs that inform investors about the risk and rewards of share ownership will help reduce the potential harmful effects sometimes associated with stock market volatility.

- At the early stage of capital market development, price limits on individual issues may be an effective means of reducing stock price volatility. However, it should be recognized that price limits, if set too narrowly, can lead to many transactions not taking place. This can result in reduced liquidity and a loss in investors' confidence. It may also raise questions about the fairness of the market in the event that individual investors believe that some market participants are subject to more favourable treatment.

- With respect to restrictions on foreign portfolio investment flows, safeguards that limit such investment to a particular type of investment vehicle such as a closed-end fund, or place limitations on the aggregate amount of investment in a particular company are preferable to exchange controls that impede the repatriation of capital and income, or policies of market segmentation (i.e. restricting foreigners to a particular class of shares). Policy options that impose

the least burden on market efficiency are preferable to those that cause price distortions or, are difficult to remove without causing serious price dislocations. Sudden policy shifts (i.e. tax treatment, exchange controls etc.) with respect to the treatment of foreign portfolio investment should be avoided.

III. VENTURE CAPITAL FUNDS

62. Venture capital (VC) originated in the United States during the 1950s as a response to the need for financing for small and medium-sized companies set up to exploit new technological advances, for example in the computing and electronic sectors. The risks inherent in financing entrepreneurs without an established track record or collateral in developing new products made them unacceptable customers to traditional commercial or investment banks. Instead, venture capitalists provided equity-type financing designed to allow them to participate in the high returns achieved by successful new ventures with high growth potential, particularly in the form of capital gains, which could compensate for the risks of a low pay off or loss from other similar, but unsuccessful ventures. Venture capital investors (or their managers) also sought to participate actively in the enterprise, for example as members of the board of directors or through reserving the right to appoint and replace key executives.

63. From these origins, the concept of venture capital has evolved in the United States and has been adapted in other countries to meet the specific needs for investment financing. In particular, VC is no longer focused on providing start-up or early stage financing; the share of early stage financing has declined in the United States, from over 40 per cent of total VC investments in the early 1980's to around 25 per cent in 1995, and in Europe from over 15 per cent to around 5 per cent. (See appendix tables 1 and 2). Since the mid-1980s, a substantial proportion of VC funding, particularly in Europe, has been directed to management buy-outs (MBOs) or buy-ins, which typically involve larger transactions than the traditional new venture. While a substantial majority of VC investment in the United States is still directed to high-technology industries (information technology and the life sciences), in Europe it is distributed over a broad range of sectors (see appendix tables 3 and 4).

64. In Western Europe there are some 500 experienced venture capital companies. Over the past 10 years, a cumulative total of about US$60 billion has been raised. The present investment portfolio of these VC institutions comprises some US$30 billion (initial cost) invested in 20,000 companies. More than half of all investments are to provide expansion finance (see appendix table 2).

65. In Japan, VC funds have be been directed to providing "mezzanine" financing (i.e. involving hybrid equity-debt instruments) for growth companies, but which have established track records of sales and earnings. In addition, there has been major developments in the institutional structure of VC financing. Initially, venture capital funding was channelled through limited liability companies established by investors who made their own investment and divestment decisions. Increasingly, venture capital has operated through dedicated financial intermediaries, often in the form of collective investment vehicles or funds, with separate legal structures for pooling and managing funds of a group of financial investors.

66. Thus, today VC can be considered as mobilisation of private-sourced equity-type funding for high risk/high reward business propositions. As such, VC has the following key characteristics:

- flexible **equity-type financing,** balancing the distribution of potential rewards to the entrepreneur/manager and "outside" venture capitalists through the use of a variety of instruments, including warrants, options or convertible securities;

- focus on high **risk-reward transactions,** in which the prospects for above average potential for growth and profitability compensate for the higher risk of failure involved;

- **active involvement** of the venture capitalist, or VC institution, in the investee company with the aim of "adding value" through financial expertise or strategic vision as well as to ensure close supervision of their investment.

67. The rationale for venture capital can be viewed generally as a means of overcoming an imbalance between (1) an inadequate supply of capital on appropriate terms from existing financial institutions and (2) a significant potential demand for funding by new or high risk ventures with prospects for high growth and profitability. The strength of this rationale as it applies to a specific country or sector has therefore to be seen in the context of both the existing financial sector of the country and the financial performance and prospects of businesses operating there. In the first case, the need for specialised venture capital institutions depends on the readiness of commercial and investment banks or capital markets to finance new or small businesses. In this context, it is clear that the availability of long-term loan financing from development banks at below market interest rates has acted, in many developing countries, as a disincentive to the development of equity-type instruments and institutions. Secondly, the case for venture capital also depends on there being good prospects for new businesses to grow and to generate significant profits for investors. In addition, the success of VC institutions in intermediating between investors and entrepreneurs depends on the ability of venture capitalists to identify and add value to promising business propositions.

A. Types of venture capital financing

68. The VC industry has increasingly distinguished between the financing needs of companies at different stages of corporate development. Thus, while companies at each stage may have financing needs which are not fully satisfied by traditional financing institutions, VC intermediaries generally specialise in one or more of types of venture capital financing. These can be categorised as follows:

- Early-stage financing
- Later-stage financing
- Special situations

69. Early stage financing VC, as in its original concept, is intended to meet the needs of new ventures for:

- Seed capital: i.e. funds for the research and development of new products, or production technologies before setting up of commercial scale production. The amount of funds for is phase is generally very limited, but the investment lead-time

is long, the risk (probability) of failure very large and later financing requirements, both for production and marketing may be considerable.

- Start-up: financing the setting up of a new (product or service) business, involving investment in fixed assets and working capital, for which the entrepreneur does not have sufficient resources. In addition to the business risks of the venture itself, this type of financing typically involves negotiation of an acceptable financial structure for the company which balances the VC investor's expectations regarding income and capital appreciation and the entrepreneur's aim to keep ownership and control.

70. **Later stage financing** In recent years, a majority of VC has been directed to funding the development of established companies, which have special financing requirements and offer attractive yield and capital growth prospects. High-growth companies may be undercapitalised and need additional risk capital to finance future growth and provide backing to support additional borrowing. Some characteristic types of development capital include:

- Expansion finance to provide working capital or fixed assets needed by unlisted companies to grow through entering new markets.

- Replacement financing to purchase the shares of entrepreneurs from their associates who wish to realise all or part of their investment without a stock market listing: often these companies have stable earnings streams making it easier to structure a profit-sharing security such as preference shares to provide the VC investor with an attractive income yield.

71. Special Situations VC has also been directed to financing certain special needs of mature companies, often components of large corporations, which can yield attractive returns, including:

- Management buy-outs (MBOs) or buy-ins (MBIs), which involve financing the acquisition of ownership and control of an existing businesses by a new management team, from within the company or outside. These typically involve the disposal by a parent company of an operating unit or subsidiary which is regarded as peripheral to its core business strategy, or is unprofitable under the previous corporate structure. Many MBOs involve major investments (in some spectacular cases of US$ 1 billion) in mature industries, and require substantial new external funding, which the new manager/shareholders are unable to provide. They are often based on highly geared or leveraged debt: equity financial structures, in which the VC investors provide funding in the form of "mezzanine" or hybrid debt: equity instruments (e.g. non-voting redeemable preference shares) which give the investors a favoured claim on cash flow but leave control with the new manager/owners. These financial structures are workable under favourable economic conditions, but become unsustainable when market or other problems reduce the cash flow available for interest or dividend payments.

- Turnaround financing is provided by some VC institutions to assist companies, which have a poor record of performance but which are basically sound and have

clear opportunities for improvement. This is a specialized form of VC, which typically involves extensive restructuring of the investee company's operations, introduction of new management, and the negotiation of complex financing to find an equitable sharing of risks and rewards between previous shareholders and lenders and the new investors.

B. Venture capital investment cycle

72. The characteristics of VC determine a distinctive process of investment and divestment. This process can be described as stages in the investment cycle.

73. The objective of investing only in propositions with high potential returns means that VC investors must be vigorous in identifying and rigorous in evaluating a large number of possible transactions. Experience of VC investors in developed markets indicates that they consider on average 150 to 250 proposals to select one which meets their rate of return or other investment criteria (e.g., size, stage of financing , market sector). VC firms therefore seek to develop extensive networks of contacts with entrepreneurs or intermediaries to source their potential "deal flow". The evaluation of VC investments characteristically focuses on whether (a) the entrepreneur has a credible business plan and (b) the ability to achieve it. This involves the VC investor in a combination of business judgements and analysis of a range of factors affecting the prospective profitability of the investee enterprise including: the technical performance of the products, services and production processes; market size, growth and penetration (market share); price/cost assumptions, particularly relative to competition; human resource availability with special attention to the mix, source and cost of essential skills.

74. The prime objective of this evaluation is to assess whether an investment in the proposed business meets the VC investor's return-on-investment targets, which typically include both a minimum internal rate of return of at least 25 per cent, and also good prospects for achieving a substantially higher return. This focus on maximum rather than average or expected returns is one of the characteristics that distinguishes VC evaluation from a banker's approach to credit or project appraisal.

75. A second distinctive feature of VC financing is the nature of the "deal" or arrangements for financing the investee company which define the basis for distributing the potential rewards of the venture. This typically involves defining and agreeing arrangements which:

- ensure that sufficient funds are provided to cover the proposed capital requirements;
- establish the valuation of the existing business and pricing formula for the purchase of new shares;
- determine the claims of each of the investors on the future cash flow (through interest payments to lenders, profit-sharing payments to managers, preferred and ordinary dividends to different classes of shareholders, and pre-emption rights on the issue of new shares) and capital gains (which may again involve different classes of shares);

- specify the decisions over which the entrepreneurs and investors have authority, including management appointments, capital expenditures, dividend policies etc.

76. The negotiation of these arrangements and the legal documentation in which they are formalised is often complex and time consuming, but are essential elements of VC financing.

77. VC investing typically involves the participation of the VC institution in the investee company. This is motivated both by the need to protect the VC institution's investment against downside risks, particularly because the investor cannot simply sell out his investment (in unlisted shares) if its performance is poor, and by the aim to "add value" to the investee company by contributing the VC firm's experience and contacts to such areas as business strategy, management organisation and processes, financial planning and control and investor relations. The extent of this involvement varies considerably between VC institutions in different countries and sectors from those with a "hands-on" approach with a close and continuous relationship with management, to a "hands-off" or passive one where the institution relies on periodic financial reporting to monitor its investments. The importance of maintaining close relationships with investee companies means that VC institution's need to be physically close to their clients and to operate with a high staffing ratio (e.g. with each VC executive handling not more than 10 investee companies).

78. The final and critical phase of the VC investing cycle is to manage the divestment or exit from the investee firm. Since realising a substantial capital gain is essential to achieving high investment returns, determining and achieving the timing and conditions of the sale of investments are key elements of the VC process. Divestments are arrived at through one of three basic exit routes:

- Flotation of the investee company's shares through an Initial Public Offering (IPO) in a stock exchange or over-the-counter market. This usually offers enhanced marketability and higher exit valuation for the investment through the higher price-earnings multiples of quoted shares: however, the investee company may be unwilling to incur the transaction costs and disclosure requirements of listing.

- Secondary or "trade sale" of the VC investor's shares to a another investor or company. This is probably the most commonly used route, although in larger, developed economies the transaction is often initiated by the acquirer which has identified the investee company as having a good strategic fit with its own operations.

- Repurchase of the VC institution's shares by the entrepreneur or the investee firm. The original contractual agreements between the investors and the entrepreneur may provide for this possibility and define the conditions for the buy back of shares.

79. The feasibility of these options depends importantly on the size and liquidity of the securities market in the country concerned, and the attitude of the entrepreneur to accepting outside shareholders.

80. The purpose of the investment vehicle or fund is to allow common investment of pooled amounts of capital from different sources. The choice of legal structure (and often of the geographic location or domicile) of the fund is made so as to provide a clear legal status and delimit the liabilities of investors, to minimize tax charges (particularly by avoiding double taxation of income or capital gains from investee companies both when received by the fund and when distributed to investors), to allow management charges and remuneration to be flexibly related to the profits of the fund and to be simple and cost-effective to administer. The most commonly used legal forms for VC institutions are:

- Corporations setting up a VC institution as a stock corporation, which was general during the early years of VC in both the United States and Europe. These have the advantages of being legally well defined, and recognised by regulatory authorities. However, stock corporations incur additional tax burdens where corporate taxes apply. In addition, they are generally intended to have an indefinite life and can be difficult to dissolve.

- Partnerships. This structure, under which investors become limited partners in a entity whose interests are managed by a general partner under defined contractual terms, has become increasingly favoured. Partnerships have the advantage that in most tax jurisdictions only the partners and not the entity are taxed. It is easy to form, to change and to dissolve. On the other hand, partnerships require detailed legal definition of the rights and obligations of the partners, and in many developing countries are not recognised as a legal entity.

- Trusts. In countries where corporations are subject to high taxes and partnerships are not legally recognised, a trust instrument may be used. Trusts can provide many of the benefits of a partnership. However, they require the appointment of an independent trustee, whose custodial duties are often incompatible with the risk-seeking objectives of a VC institutions and whose services impose additional expenses and restrictions on management action.

81. The increasing interest of international institutional investors in cross-border investment has stimulated and been assisted by the development of offshore financial centres, providing favourable legal and tax regimes for investment fund vehicles.

82. While a number of specialised VC companies were established in the late 1970s - e.g. in the Philippines and Brazil - these were a rarity. Equity financing for private enterprises in these countries was primarily provided by development finance institutions (DFIs) , both in the developing countries themselves and through government-sponsored agencies in the capital exporting countries. However, these DFIs operated primarily as term-lenders. Equity investments comprised a small proportion of their total financing, and were focused on strengthening the capital base (and borrowing capacity) of investee businesses, generally small and medium-sized enterprises, rather than on building a portfolio of high return shareholdings. Neither the operating policies nor the staff resources of these DFIs encouraged active involvement in the investee firm essential to the VC approach. This pattern of financing, which represented a very diluted form of VC, reflected the impact of a range of obstacles to the emergence of risk capital,

including the lack of entrepreneurship, high capital gains taxation and the undeveloped state of local securities markets, as well as the availability of relatively cheap loan funding.

C. Recent developments

83. Since the late 1980s there has been spectacular increase in risk capital financing in developing countries. On the one hand there has been a rapid growth of portfolio investment by institutional investors from developed countries in the equity securities of what have become redesigned "emerging market" issuers. On the other hand, there has been a multiplication of specialised VC institutions: many of these are structured as two-tier investment funds, with management provided by professional fund managers from international capital centres. While VC institutions have been established in a wide range of countries, including several of the least developed (e.g. Bangladesh, Madagascar, Mozambique, Uganda), the major expansion has been concentrated in Asia and the transition economies of Eastern Europe.

84. It is estimated that the pool of investable VC funds in South and East Asia, excluding infrastructure, has increased rapidly over the past 10 years from US$500 million to US$6 billion. Several major regional and international financial institutions, including HBSC, Development Bank of Singapore, AIG Investment Corporation (Asia) have established VC or private equity funds. There has been a similar rapid expansion of VC financing in Eastern Europe and CIS. By 1995, it is estimated to have grown to 72 funds with total committed capital of about US$4.5 billion. The European Bank for Reconstruction and Development (EBRD) has actively supported the creation of equity funds in the region: By the end of 1995, EBRD had committed over ECU 200 million (US$240 million)in 21 private sector sponsored and managed funds ranging from country funds providing seed and early-stage capital to local companies to large regional funds that provide equity capital to joint ventures between local and Western companies.

85. Unlike previous periods, the recent development of VC has been concentrated in dedicated risk capital institutions, with specialised management focused primarily on achieving high financial returns through capital gains in growth enterprises.

86. This overall pattern of development has been mirrored by the experience of IFC. Over the past two decades, the International Finance Corporation (IFC) has promoted venture capital funds in developing countries in an effort to improve the access of small and medium-firms to equity finance and management expertise. IFC has worked with institutional investors, investment banks and fund managers in structuring funds, identifying fund managers and placing funds. By 1996, it had invested US$196 million in 49 venture capital funds, with a total initial capital of US$1.5 billion. Some of the salient features of IFC's experience have been:

- IFC made its first investments in VC institutions in the late 1970's: several of these had more of the character of small business development corporations (e.g. VIBES in the Philippines) which provided short-term financing or investment trusts (e.g. IPS in Kenya).

- IFC's investment in investment fund vehicles has grown rapidly, accelerating over the past five years.

- The average fund size has been US$30 million, although recent funds have ranged up to US$100 million.

Table 2

Region	1978-1984		1985-1989		1990-1995	
	Number of Funds	Fund Cap. US$m	Number of Funds	Fund Cap. US$m	Number of Funds	Fund Cap. US$m
Africa	1	4.0	1	3.3	4	38.4
Asia	4	44.5	2	38.4	16	507.7
Central Asia/Middle East	0	0.0	0	0.0	1	25.0
Europe	1	6.8	4	119.9	12	624.5
Latin America	1	12.1	3	94.5	1	14.0
Total	7	67.4	10	256.1	34	1,209.6

Source: International Finance Corporation

- VC investments have been heavily concentrated: over 85 per cent in Asia and the emerging and transitional countries of Europe.

- Financial returns on its active and closed investments in VC funds have been poor: the IRR on these VC investments has been only 1.9 per cent as against 26.2 per cent for portfolio funds. However, many of the early VC vehicles supported by IFC were the first in their markets and faced particular problems in attracting resources and building up a deal flow.

- IFC funds have increasingly worked in partnership with experienced, international professional fund management companies (e.g. Advent, Framlington), sometimes in association with local partners to provide access to market contacts and information. In South-East Asia, IFC has supported a regional fund manager SEAVI which is managing a series of funds in the region.

Kenya Equity Capital

Kenya Equity Capital (KEC) was established in 1986 to invest in the equity of unquoted Kenyan companies, funded in part by soft loans from USAID and grants to support management costs. Difficulties in finding promising equity investments in either small enterprises (less than US$1 million was committed in five companies) many of which were unwilling to accept outside shareholders, or larger firms which could raise bank financing, led the managers to abandon VC in favour of providing fund-raising services on a fee-earning basis.

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87. The Commonwealth Development Corporation (CDC) has also rapidly expanded its VC activities in the developing countries in which it operates. It has invested US$135 million, as of the end of 1996, in 25 investment capital funds. In less developed countries, particularly in sub-Saharan Africa, CDC has promoted 13 managed funds, in which it has invested US$107 million of total US$235 million raised, and is providing management (see Appendix, Table 6). Reflecting the characteristic industrial and financial structure of these countries, CDC's managed investment funds are generally relatively small: six of them were capitalised at less than US$10 million each. They target a broad range of potential equity or quasi-equity investments in start-ups, expansions or privatisation/rehabilitation with prospects for attractive returns in a 4-6 year period. Their initial exit strategies are focused on trade sales or repurchase agreements. As few of these funds have reached the realisation stage, it is too early to assess their investment performance. CDC fund managers are remunerated by annual management fees and carried interest but are also supported by subsidies from the United Kingdom and international donor agencies.

88. Several factors have contributed to stimulating increased VC investment in emerging markets.

- The investment climate in many of these countries has improved substantially as a result of generally favourable developments of the world economy which are benefiting in particular those countries that have followed policies of macro-economic stabilization, liberalisation of financial markets and foreign investment regulations, resolution of the debt crisis (especially for Latin American countries), privatization programmes, etc.;

- Institutional investors in developed countries have been actively seeking out new opportunities as a result of declining interest rates and investment returns in advanced markets, and the relaxation of restrictions on overseas investment by institutional investors. The process of portfolio diversification has been driven by the promotion of a wide range of investment fund vehicles designed to offer institutional investors exposure to specific regions or types of investments.

- Advances in information and communication make it easier to buy into emerging markets.

Tunisia

The first VC institution in Tunisia - la Société de Participations et de Promotion des Investissements (SPPI) - was established in 1990 with a capital of DT 5.5 million (US$6 million equivalent). These funds were invested over a four year period in 28 investee companies, or a rate of less than US$1 million per year. During the same period, the major Tunisian development banks were effectively undermining the potential demand for external risk capital. The development banks typically provided medium- and long-term loans of up to 70 per cent of total financing requirements, even for start-up enterprises, and in addition extended a share of the equity funding, but with a repurchase contract and in the form of an interest-bearing redeemable security. These policies resulted in entrepreneurs financing new business ventures with around 10 per cent of real risk capital.

89. **Structure of VC Vehicle** The design of a VC institution can also have a major impact on its results in a number of ways.

- First, the size of a fund in terms of capital is important. Small funds have generally performed worse than larger funds: VC funds in which IFC has invested with less than US$10 million capital had yielded negative returns compared to a weighted average 3.9 per cent return for larger funds. There are several reasons for this. Small funds have been less able to attract or retain good managers and to cover the fixed costs of running the fund (a typical remuneration formula based on a fixed fee of 2.5 per cent of commitments would yield fee income of only US$250,000 per year). In addition, it is more difficult for a small fund to adequately diversify its investments to spread its risks: to build a portfolio of 15-20 investments would involve investing in small companies (less than US$500,000 each) which are often less well adapted to working with outside investors.

- Secondly, the choice of organizational structure - essentially between a one- or two-tier structure, or between a limited- or indefinite-life legal entity - is critical to ensuring clarity in the investment objectives of the fund. Based on problems that arose with several early VC investments - for example, where individual investors through their membership of the Board of a single-tier company exercised excessive influence on investment decision in contradiction to concentration limits set in agreed investment policies - IFC has concluded that a two-tier structure is preferable. This has also become the general model for emerging market funds, acceptable to major international institutional investors.

- Thirdly, the formula for remunerating fund managers determines whether management has effective and transparent incentives to manage the VC institution's resources so as to maximize returns to the investors. Management fees for internationally managed VC funds have increasingly been based on commonly

accepted industry standards, incorporating (i) an annual fee, typically equivalent to 2-3.5 per cent of committed capital less distributions to investors and (ii) a performance fee or "carried interest" based on a share of distributed profits (say 20 per cent) over a stipulated hurdle discounted rate of return on the investors' original capital (say 10 per cent).

D. Potential benefits

90. Against the background of past experience, the potential benefits of VC in developing countries need to be examined as well as the conditions that must be met for VC financing to be successful.

91. VC provides an institutional mechanism for stimulating the flow of equity funds into productive investment, which can benefit (i) business firms needing capital, (ii) financial investors seeking attractive returns and (iii) host governments interested in the growth and development of the economy.

92. Firms shareholders' capital or equity funds have a critical function in the structure of business enterprises. This is particularly true of small, closely-held companies which form the bulk of the private enterprise sector in developing countries. VC funding supplements the generally limited financial resources of younger firms owned by entrepreneurs and their families.

- Reinforce the financial structure Since shareholders only receive dividends when the firm makes a profit, equity funding provides not only long-term funds to allow it to make initial investments but a margin of financial security to borrow to finance its further growth. This margin reduces the risks to creditors of not being repaid, even if results are not as good as expected, and encourages them to lend to a business at lower interest rates.

- Provide managerial expertise VC institutions, when professionally run, can provide investee companies with the benefits of a broad range of technical and commercial knowledge or expertise. Foreign VC investors or investment managers can often provide invaluable assistance in launching a company, in penetrating new markets or in dealing with financial institutions based on their previous experience and contacts.

93. VC institutions provide vehicles for institutional and other financial investors to participate in the financing and share in the profits of privately-held businesses with good growth prospects.

- Diversification of investment. Equity investments in new or smaller businesses represents opportunities for high returns (with commensurate risk) which are not readily open to institutional investors, either local or international. Investment in a VC fund or institution provides a mechanism for these investors to access a portfolio of potentially high-yielding investment.

- Professional management. Well-structured VC institutions mobilize professional investment managers with the specific skills, experience and motivation to evaluate

and manage private equity investments that are significantly different from those available to institutional investors specialising in widely-traded securities.

94. Dynamic VC institutions also make broader contributions to the economies in which they operate.

- Through encouraging investment in small, but fast growing companies - VC investments can make an important contribution to economic growth and employment. Research on the impact of VC in a number of developed countries demonstrates that firms financed by VC grew substantially faster than comparable larger firms: for example, in the Netherlands, 40 per cent of the fastest growing companies had been financed with VC.

- VC equity investments help develop local capital markets by increasing the supply of marketable securities - particularly where the option of divestment through IPOs on local stock exchanges is available. In addition, by encouraging the use and availability of detailed financial information about investee companies, VC helps overcome the information asymmetries which hinder effective and objective assessment by many outside investors.

United Republic of Tanzania

The promoters of the Tanzania Venture Capital Fund Ltd. sought the following assurances and exemptions:

1. Confirmation that gains and losses on sales of investment will not be treated as income and expenditure and subject to corporation tax, and that if a capital gains tax were introduced in United Republic of Tanzania, TVCF would be exempt from it.

2. Exemption from dividend restriction legislation.

3. Exemption from withholding tax on dividends and interest paid by investee companies where TVCFs shareholding is less than 25 per cent.

4. Exemption from withholding tax on dividends paid by TVCF to its own shareholders.

E. Elements for success

95. Successful VC operations have certain basic common features. These can be regarded as essential conditions that need to be fulfilled when setting up new VC institutions.

96. The success of VC depends on finding opportunities for investment with high growth *potential within its target market (e.g. country, sector). Given the need for highly selective*

screening of business propositions to generate a well-balanced and diversified portfolio, the first essential condition for any new VC fund is the availability of a substantial "deal flow". To close 5 deals a year, a VC firm needs to identify and evaluate a flow of at least 100 serious new inquiries. The availability of attractive business opportunities for VC in turn depends on:

- Growth market sectors: while few developing countries are able to create or support high-technology enterprises that have been characteristic of VC financing in the United States, they can offer attractive market niches based on specific comparative advantages or the application of new technologies or deregulation, e.g. to agrobusiness, horticulture, telecommunications, etc.

- Entrepreneurial quality: entrepreneurs with business judgement and managerial skills are also essential to manage the transformation of the deal into a successful enterprise. Given the frequent lack of a social tradition of business management in developing countries, it is difficult to judge the quality of business promoters based on a track record. Nevertheless, the ability of the entrepreneur to focus on a single business opportunity, to think strategically about the issues critical to its success, and to ensure the preparation of adequate financial information, are all essential. The VC manager can assist and guide the entrepreneur but cannot substitute for him.

- Equity culture: entrepreneurs need to understand and accept the basis of the business relationship with outside equity investors. This relationship needs to be based on the principles of common interest, transparency in the sharing of information, participation in major decisions and equity in the distribution of profits. Changing attitudes is a difficult, time consuming business. A VC firm can have an important educational role in explaining and encouraging constructive relationships between entrepreneurs and investors.

97. The performance of VC operations depends largely on the skills and the commitment of VC managers. This calls for identifying and retaining international managers with a relevant track record:

- Professional skills: successful international VC managers typically have broad management experience, often including marketing or technical background, as well as financial expertise. These people are scarce, especially for work in difficult environments, but they are invaluable. Institutional investors generally require that the managers of funds in which they invest can demonstrate a proven track record. The quality of management is critical to the success of VC institutions. VC managers have a key role in identifying and evaluating investment propositions, in structuring and negotiating deals and in managing and divesting the portfolio of equity holdings. This is as true for relatively small VC funds in difficult environments as in more developed markets. However, the supply of potential VC managers in developing countries is virtually non-existent. A good venture capitalist will learn through experience, but this takes time and the poor performance of inexperienced managers will impact on the initial results of a VC institution. In one fund supported by IFC, where the manager had no prior VC experience (and no support from a technical partner), the first nine investments made were failures. In this connection, the experience of

government-sponsored institutions in managing VC operations has been unsatisfactory. Occasionally, both public sector DFI's or specialised VC institutions have been subject to political influence in selecting projects on the basis of generalised sector priorities rather than the merits of the specific transactions. In addition, these institutions have been too passive managing their portfolios, either in realising gains through disposals or limiting losses through liquidation.

- Local knowledge: VC managers also need to have close knowledge of the specific markets in which they operate. An up-to-date understanding of local conditions and a network of contacts with prospective investee businesses are critical to generating dealflow, and to assessing the specific factors that will determine growth potential and to identifying the right method and timing of exits.

- Efficient incentive remuneration: To attract well-qualified managers and to concentrate their attention on maximising returns on invested funds, the remuneration of VC managers needs to be structured according to include strong profit-related incentives based on widely-accepted industry formulae. The cost of these remuneration packages also has a significant impact on determining the minimum economic size for a VC fund, generally regarded as at least US$20 million: to accommodate this cost structure in developing countries, the fund managers may operate on a regional basis, or a portion of the management costs may be supported by donor agencies.

98. A third requirement for the success of VC in developing countries is that the business environment should be supportive of productive private sector investment and of equity financing. Apart from macroeconomic policies, the system should provide for:

- Legal and regulatory framework designed to favour the creation and operation of VC funds, the protection for minority shareholder's rights, the transfer of share-ownership and the speedy and equitable settlement of commercial disputes.

- Tax regime that ensures a transparent and equitable treatment of company profits, dividends and capital gains, and the tax-free pass through of returns to a VC fund and its investors. Confiscatory tax policies, particularly on capital gains, effectively eliminate the prospects for financially viable VC financing. In cases where the tax system is undeveloped, it will be essential to secure clarification and assurances from the authorities about the treatment that a VC vehicle will receive.

- Exit mechanisms. The ability to liquidate investments freely and with substantial capital gains is critical to the success of VC. Exits are clearly easier where there is an active stock market. The limited choice of "exit" options for divesting makes it difficult in many developing countries to realise the substantial capital gains needed to achieve the high returns. IFC's experience indicates that where local stock markets are inactive (annual turnover of less than US$3 billion), stock prices low (valued at less than 10 times earnings-per-share) or IPOs hindered by regulatory constraints,

capital gains were lower than in countries with an active and liquid capital market.[30] While there has been rapid development of stock markets in developing countries over the past five years - there are now 10 in sub-Saharan Africa - it takes time before young stock exchanges have the depth and liquidity to absorb flotation of new ventures. On the other hand, the flow of VC funding into East European transition economies shows that international investors have been prepared to invest in new ventures there in anticipation of the evolution of local stock markets into viable exit mechanisms. However, in the less developed countries, even where these markets exist, they do not yet provide a ready mechanism for floatation of small and medium-sized enterprises. In the absence of an active stock market, VC firms will then rely on other exit routes: trade sales, portfolio sales to institutional investors with the resources and policies to allow them to take equity participations or repurchase agreements with project promoters. The feasibility of achieving a significant volume of potential divestments in a particular country will depend on the size and stage of development of the corporate and financial sectors.

- Financial infrastructure VC operations also need the support of efficient service providers including accountants, lawyers and bankers as well as communications facilities.

99. Institutions providing VC also need to be structured to ensure a maximum flexibility of operations while meeting the interests of the investors providing the funds. To do this, the following factors are important:

- Legal form and domicile: a VC institution should be established under a legal jurisdiction which allows simple incorporation, flexibility in raising funds and wide discretion in defining investment policies. Institutional investors also often require that fund vehicles that deal in illiquid, unquoted investments are established with a finite life (7 to 10 years) at the end of which all investments should be liquidated and the funds returned to investors.

- Separation of ownership and management is important to ensure that responsibility for investment and divestment decisions clearly rests with the professional manager, but that investors have reasonable assurances about the use and recovery of their funds. There is general consensus that this is best achieved through the two-tier structure, where the investment vehicle is legally and operationally distinct from the fund management entity. Investors will generally nominate members to the fund's board or advisory panel to determine basic investment (asset allocation) policies and review fund performance.

- Defined statement of investment objectives and policies. As a corollary to the delegation of operating responsibilities to investment managers, VC investors will typically want to be satisfied that the fund or institution has set specific objectives and policies in terms of hurdle rates of return; target investments (by size, sectoral focus,

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[30] *Investment Funds in Emerging Markets*. International Finance Corporation. 1996. page 28.

or stage of corporate development); type of investment instruments to be used (e.g. convertible debentures, income notes); time horizons for full investment, divestment and distribution of funds to investors; principles for valuing unquoted investment; reporting to investors, etc.

APPENDIX

UNITED STATES
VENTURE CAPITAL INVESTMENT BY STAGE

Appendix 1

% of $ value

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Seed Money	2	2	2	3	2	2	2	2	4	3	1	2	1	1	1
Start-up	40	37	33	31	22	31	26	30	24	24	21	27	24	19	25
Total Early Stage	42	39	35	34	24	33	28	32	28	27	22	29	25	20	26
Expansion	44	51	52	54	60	44	54	48	47	52	63	59	59	64	57
LBOs			10	9	11	18	11	19	21	18	11	8	13	14	16
Other	14	10	3	3	5	5	7	1	4	3	4	4	3	2	1
TOTAL	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Sources: Venture Capital Journal, National Venture Capital Association Annual Report

EUROPEAN VENTURE CAPITAL
INVESTMENT BY STAGE
% of value

Appendix 2

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Seed Money	0.5	1.1	0.3	0.9	0.7	1.0	1.0	0.5	0.7	0.6
Start-up	16.9	11.0	12.3	9.0	7.7	5.9	5.9	4.4	5.0	5.2
Total Early Stage	17.4	12.1	12.6	9.9	8.4	6.9	6.9	4.9	5.7	5.8
Expansion	57.5	50.4	41.4	39.8	48.2	52.6	52.6	45.9	42.2	41.4
LBOs	25.1	37.5	38.6	44.8	36.8	34.6	34.6	40.8	44.1	46.4
Other (replacement)	-		7.4	5.5	6.6	5.9	5.9	8.4	8.0	6.4
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: European Venture Capital Association Yearbooks

Appendix 3

UNITED STATES
VENTURE CAPITAL INVESTMENT BY SECTOR

1991-95

Sector	US $ million	% of total
Communications	4329.4	17.8%
Electronics & Computers	1967.8	8.1%
Semiconductors & Components	1088.8	4.5%
Software & Services	3521.9	14.5%
Total: Information Technology	10907.9	45.0%
Medical Compounds	3349.6	13.8%
Medical Equipment	2435.6	10.0%
Healthcare Services	1504.3	6.2%
Total: Life Sciences	7289.5	30.0%
Retailing & Consumer Products	2761.8	11.4%
Environment	307.7	1.3%
Other	2994.3	12.3%
Total:Non-Technology	6063.8	25.0%
TOTAL	**24261.2**	100.0%

Source: National Venture Capital Association Annual Report 1995

Appendix 4

EUROPE
VENTURE CAPITAL INVESTMENT BY SECTOR

1991-95

Sector	ECU million	% of total
Communications	701	2.9%
Electronics & Computers	1,313	5.4%
Other Electronics	887	3.6%
Total: Information Technology	2,901	11.9%
Biotechnology	398	1.6%
Medical/ Healthcare	1,057	4.3%
Total: Life Sciences	1,455	6.0%
Consumer Products	5,107	20.9%
Industrial Products	3,470	14.2%
Energy	450	1.8%
Chemicals	856	3.5%
Industrial Automation	229	0.9%
Transportation	1,267	5.2%
Financial Services	905	3.7%
Other services	2,527	10.3%
Other manufacturing	2,735	11.2%
Agriculture	485	2.0%
Construction	1,026	4.2%
Other	1,023	4.2%
Total:Non-Technology	20,079	82.2%
TOTAL	**24,434**	**100.0%**

Source: National Venture Capital Association Annual Report 1995

IFC INVESTMENTS IN VENTURE CAPITAL FUNDS

Appendix 5

REGION	1978-84 Country	1978-84 Fund Cap. US $ m	1985-89 Country	1985-89 Fund Cap US $ m	1990-95 Country	1990-95 Fund Cap. US $ m
Africa	Kenya	4.0	Cote d'Ivoire	3.3	Madagascar FIARC	4.4
					Madagascar FIARC	2.2
					South Africa	15.0
					Zimbabwe	16.8
Total		4.0		3.3		38.4
Asia	Korea	13.3	China	23.0	China (Walden)	83.8
	Malaysia	5.0	Philippines	15.4	China (CDGF)	100.0
	Philippines	1.2			China (Newbridge)	100.0
	SE Asia VC	25.0			India (TDICI)	60.0
					India (Indus)	10.5
					India (Tech Fund)	3.9
					Indonesia (Seavi)	5.0
					Indonesia (Pru)	45.0
					Indonesia (PT)	5.0
					Korea	12.1
					Malaysia	5.0
					Pakistan	6.8
					Philippines	9.0
					Philippines(H&Q)	15.9
					Thailand	5.7
					Seavi III	40
Total		44.5		38.4		507.7
Central Asia/M East					Egypt	25.0
Total						25.0
Europe	Spain	6.8	Hungary	80.0	Bulgaria	30.0
			Portugal (Inter-ris	4.7	Czech	20.0
			Portugal (Inter-ris	2.1	Hungary	19.4
			Portugal (Finantia	33.1	Russia NIS	180.0
					Poland	23.2
					Slovenia	25.0
					E Europe (Alliance)	50.0
					New Europe East	129.6
					Advent Europe	40.1
					Renaissance	30.0
					Russia	65.4
					Ukraine	11.8
Total		6.8		119.9		624.5
Latin America	Brazil	12.1	Argentina	10.0	Brazil	14.0
			Jamaica	4.5		
			Mexico	80.0		
Total		12.1		94.5		14.0
GRAND TOTAL		**67.4**		**256.1**		**1,209.6**

CDC MANAGED INVESTMENT CAPITAL FUNDS

FUND NAME	COUNTRY	EQUITY %	CDC COMMITMENT (US$000s)	FUND SIZE (US$000s)	MOBILISATION RATIO
Tanzanian Venture Capital Fund	Tanzania	32.9%	2,500	7,605	2.04:1
Ghana Venture Capital Fund	Ghana	34.5%	2,000	5,800	1.90:1
Commonwealth Africa Fund	Sub-Saharan Africa	39.4%	25,000	63,500	1.54:1
Zambia Venture Capital Fund	Zambia	34.2%	2,500	7,300	1.92:1
Development Finance Co of Uganda*	Uganda	25.0%	1,425	5,000	2.51%
Mauritius Venture Capital Fund	Mauritius	21.4%	1,600	7,462	3.66:1
Enterprise Capital Fund	South Africa	50.0%	13,500	27,000	1.00:1
Takura Fund	Zimbabwe	29.2%	4,000	13,700	2.43:1
Acacia Fund	Kenya	28.3%	5,000	17,683	2.54:1
PNG Venture Fund	Papua New Guinea	100.0%	4,500	4,500	0.00:1
Nandi Investment Fund	India	100.0%	30,000	30,000	0.00:1
NDB Venture Investments	Sri Lanka	36.8%	7,000	19,000	1.71:1
Central American Investment Fund	Costa Rica	30.4%	8,000	26,356	2.29:1%
Total			107,025	234,906	1.19:1

*CDC commitment is in DFCU - the fund is part of the whole equity portfolio